UNITED STATES DISTRICT COURT

DISTRICT OF DELAWARE

JEFFREY T. STRAUSS, derivatively on behalf of AFFILIATED COMPUTER SERVICES, INC., Plaintiff, v. JEFFREY A. RICH, MARK A. KING, and AFFILIATED COMPUTER SERVICES, INC., Defendants.	**C.A. No. 06-318-SLR**

PLAINTIFF'S MEMORANDUM OF LAW
IN OPPOSITION TO MOTIONS TO DISMISS

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Preliminary Statement

This case arises out of the backdating of certain options issued to two executives of Affiliated Computer Services, Inc. ("Affiliated" or the "Company"). "Backdating" generally refers to dating an option grant to predate the actual award date in order to provide for an exercise price lower than the market price of the company's stock on the actual grant date.

The ramifications of this conduct are significant from an accounting and legal perspective, but particularly in the securities laws. In his complaint, plaintiff Jeffrey T. Strauss, suing derivatively on behalf of Affiliated, alleges that short-swing profits of approximately $7.1

million were generated to the individual defendants as a consequence of this backdating scheme, which must be disgorged pursuant to §16(b) of the Securities Exchange Act of 1934 ("§16(b)").

Strauss submits this memorandum of law in opposition to: 1) the motion of defendants Jeffrey A. Rich ("Rich") and Mark A. King ("King") to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6); and 2) Affiliated's motion to dismiss the complaint for failure to make a proper demand. Specifically, Rich and King (the "individual defendants") argue that the statute of limitations bars the claims and that the transactions identified in the complaint are exempt from the application of §16(b) by SEC Rule 16b-3(d).

We show below that all of these motions should be denied. First, with respect to the individual defendants, the statute of limitations is no bar to this action because it has been equitably tolled by the defendants' failure to make accurate disclosure in their SEC Form 4 and Form 5 filings concerning their options grants. These filings falsely stated that the options were granted on a date certain and that the transactions were entitled to an exemption as *bona fide* option grants. The complaint alleges that these option grants were backdated, that the grants were fraudulent and that defendants' claim to the exemption were improper and incorrect. As we show in Point I, *infra*, the failure of Rich and King to make full and accurate disclosure tolls the running of the limitations period.

Second, the individual defendants are not entitled to an exemption under SEC Rule 16b-3(d) for the options grants. The exemption provided by this Rule is limited to *bona fide* transactions between the issuer and insiders where the SEC has determined there is a reduced opportunity for speculative abuse. As we show below, this is plainly not such a case and thus the SEC rule does not provide any shelter from liability for Rich and King. (Point II, *infra*)

Third, the complaint should not be dismissed for failure to make a demand on the board to commence this lawsuit. Unlike traditional state law shareholder derivative suits, such a demand is not strictly required under §16(b), especially where it is plain that the corporation will not bring it or where the limitations period is at risk. Because both of these factors are present here, demand was excused and the motion to dismiss by Affiliated should be denied. (Point III, infra)

Facts

The complaint alleges the following facts which must be considered true on this motion.

On or about March 6, 2006, the Company filed a Form 8-K with the Securities and Exchange Commission reporting that the SEC was conducting an investigation into the Company's option grant practices for the period from October 1998 through March 2005. Rich was granted options

to purchase 100,000 shares effective July 11, 2000 at an exercise price of $32.875 per share; Rich was granted additional options to purchase 400,000 shares effective July 23, 2002 at an exercise price of $35.75 per share; and King was granted options to purchase 200,000 shares effective July 23, 2002 at an exercise price of $35.75 per share. Each of these grants was backdated to improperly take advantage of historically low trading prices of the Company's stock.

Rich and King caused the Company to manipulate the price of the stock options in order to benefit themselves. In particular, the artificial grant dates provided Rich and King with lower exercise prices. Because the Company used artificial grant dates, these stock option grants were not granted in conformance with the requirements of the Company's stock option plans and were not properly approved by the Company under SEC Rule 16b-3(d). Under SEC Rule 16b-6(a) and (c), 17 C.F.R. § 240.16b-6(a) and (c), these option grants are therefore deemed to be purchases of the same number of shares underlying the options at a price per share equal to the market price on the actual date of the grants. *See, Magma Power Company v. The Dow Chemical Company*, 136 F.3d 316,321-322 (2d Cir. 1998). These purchase prices are believed to be $33.25 in the case of

the option granted effective July 11, 2000, and $37.00 in the case of the options granted effective July 23, 2002.

During the period of 2000 through 2002, Rich and King engaged in sales of the Company's stock at various times that occurred within six months of the backdated option grants set forth above. Rich sold at least 100,000 shares within the six-month statutory period of the July 2000 option grant at prices ranging between $46 and $64 per share, garnering short-swing profits of at least $3 million. Rich also sold 208,000 shares between January 29, 2002 and January 21, 2003 at prices ranging between $44 and $56, garnering short-swing profits of at least an additional $3 million. King sold 72,000 shares between May 21, 2002 and January 22, 2003 at prices ranging between $49 and $55, garnering short-swing profits of at least $1.1 million.

Rich and King reported the foregoing option grants in Form 4 and Form 5 filings with the SEC, wherein they assert that these option grants were exempt from the statute under SEC Rule 16b-3(d). 17 C.F.R. § 240.16b-3(d)(1). Because the options were not granted in the ordinary course of business, or in accordance with the terms of the governing options plans, and were illegally backdated, this exemption is unavailable.

Governing Law

Section 16(a) of the Exchange Act ("§ 16(a)") defines insiders as "[e]very person who is directly or indirectly the beneficial owner of more than ten per centum of any class of any equity security . . . which is registered pursuant to section 12 . . . or who is a director or an officer of the issuer of such security." *Id.* Section 16(a) requires statutory insiders to file ownership reports with the SEC upon becoming subject to the statute setting forth the amount of all equity securities of the issuer of which the insider is a beneficial owner. Thereafter, if there is a change in the insider's ownership position, the insider is required to file an amended statement of ownership within two business days of the transaction.

Section 16(b) of the Exchange Act provides that if a statutory insider purchases and sells or sells and purchases shares of any equity security of such an issuer within a period of less than six months, any profits arising from those transactions are recoverable by the issuer. [1]

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[1] Section 16(b) reads as follows: "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . shall inure to and be recoverable by the issuer." 15 U.S.C. §78p(b).

Under SEC Rules 16b-6(a) and (c), 17 C.F.R. § 240.16b-6(a) and (c), derivative securities, like option grants, are deemed purchases of the same number of shares underlying the options at a price per share equal to the market price on the actual date of the grants. These purchases can be matched with sales made during the prior and/or subsequent six-month period to compute disgorgeable profits.

Option Backdating

"Backdating" is a manipulative practice that, among other things, conceals the transfer of shareholder equity to executives. "Backdating" is a particularly abusive scheme when, as is the present case, executives sell substantial shares at artificially inflated prices (due, in large part, to misleading financial statements resulting from the backdating) within a period of six months of receiving backdated options. In such cases, executives are, in effect, betting on a horse race after the finish, because they effectively are purchasing shares (i.e., the shares underlying their options) at the lower, predated price, and then turning around and selling their shares. This kind of abusive scheme is exactly what Congress sought to curtail by enacting Section 16(b) of the Securities Exchange Act of 1934. *Kern County Land Co. v. Occidental Petroleum Corp.,* 411 U.S. 582, 594 (1973).

In the present case, defendants abused their positions as executives to benefit from backdated options and sold their shares within six months.

Standards on a Rule 12(b)(6) Motion

A motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) must be denied "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46, (1957); *Goldman v. Belden*, 754 F.2d 1059, 1065 (2d Cir. 1985). A Rule 12(b)(6) motion is designed to "test the formal sufficiency of the statement of claim for relief. The motion is viewed with disfavor and is rarely granted". *Walsh v. McGee*, 918 F. Supp. 107, 112 (S.D.N.Y. 1986) (quoting *Wright* & *Miller* §1350). "A complaint should be dismissed only if, after accepting as true all of the facts alleged in the complaint, and drawing all reasonable inferences in the plaintiff's favor, no relief could be granted under any set of facts consistent with the allegations of the complaint". *Trump Hotels & Casino Resorts, Inc. v. Mirage Resorts, Inc.*, 140 F.3d 478, 483 (3d Cir. 1998). The moving party has the burden of persuasion. *See, Kehr Packages Inc., v. Fidelcor, Inc.*, 926 F.2d 1406, 1409 (3d Cir. 1991).

POINT I

THE COMPLAINT IS NOT BARRED BY THE STATUTE OF LIMITATIONS

Defendants are correct that the statute of limitations on a §16(b) claim runs for two years from the date of the transaction that led to the profits until the filing of the complaint. In this case, that two year period has expired. However, plaintiff submits that the limitations period has been tolled in this case as a result of defendants' failure to make proper filings with the SEC.

Although there is no controlling Third Circuit authority as to equitable tolling under §16(b), there are two Circuit level decisions permitting tolling of the statute of limitations that are applicable here. Both the Ninth and Second Circuits have held that, where the defendants fails to make proper filings with the SEC as required by §16(a), the two-year period is tolled until the filing is made. See, *Whitaker v. Whitaker Corp.*, 639 F. 2d 516, 527-30 (9th Cir.), *cert denied*, 454 U.S. 1031 (1981); *Litzler v. CC Investments, Ltd.*, 362 F.3d 203 (2d Cir. 2004). The defendants' filings in this case did not properly report the option grants and under the rationale of either Circuit decision, this action is timely.

The complaint alleges that although the individual defendants filed Forms 4 and 5, they improperly indicated on the Forms that the transactions were entitled to an exemption under Rule 16b-3(d). A review of the Forms 4 and 5 attached to defendants' motion papers shows that the option grants were designated with an "A" indicating that they constituted a "grant, award or other acquisition pursuant to Rule 16b-3(d)" and were thus exempt from §16(b). Instructions to Form 4, **http://www.sec.gov/about/forms/secforms.htm#1934forms.** Because these were backdated options and thus were not *bona fide* transactions entitled to the exemption, a correct SEC filing would have designated these transactions with a "P" indicating that they constituted an "open market or private purchase of non-derivative or derivative security". *Id.* That designation would have made it clear that a §16(b) disgorgement claim existed. Here, the defendants' filings misled the public into believing there was no such claim. The tolling rule is designed to remedy this type of deception.

The policy behind the tolling of the limitations period is succinctly summarized by the *Whitaker* court:

> However, examining the legislative purpose of §16 as a whole and considering the place of the time provision in that overall legislative scheme, we

> infer that tolling of the two year time period is required when the pertinent §16(a) reports are not filed. The legislative history and purpose of §16, discussed in Part II-A above, clearly reveal a strong congressional intent to curb insider trading abuses. This purpose would be thwarted if insiders could escape liability by not reporting as required under § 16(a). "(I)t would be a simple matter for the unscrupulous to avoid the salutary effect of Section 16(b) which provides a remedy for the recovery of short term profits, simply by failing to file monthly reports in violation of subdivision (a) and thereby concealing from prospective plaintiffs the information they would need to adequately protect their interests. Such a construction would reward the violation of the statute and would manifestly frustrate congressional intent." Blau v. Albert, 157 F.Supp. 816, 819 (S.D.N.Y.1957). Accord Grossman v. Young, 72 F.Supp. at 378-79.
>
> * * *
>
> In summary, we hold that an insider's failure to disclose covered transactions in the required s 16(a) reports tolls the two year limitations period for suits under § 16(b) to recover profits connected with such a non-disclosed transaction. (footnote omitted) The two-year period for s 16(b) begins to run when the transactions are disclosed in the insider's § 16(a) report. See Blau v. Albert, 157 F.Supp. at 819; Shattuck Denn Mining Corp. v. La Morte, supra. This interpretation is consistent with the legislative scheme of § 16. It is supported by prior cases construing the section and by securities commentators. The district court's result on the limitations issue is therefore reversed.

Whittaker v. Whittaker Corp., 639 F.2d 516, 528, 530 (9th Cir. 1981).

In *Litzler*, the Second Circuit took a similar approach, holding that "the two-year limitations period of Section 16(b) is subject to equitable tolling when a

covered party fails to comply with Section 16(a) and that such tolling ends when a potential claimant otherwise receives sufficient notice that short-swing profits were realized by the party covered by Section 16(a)."
362 F.3d 203, 205 (2d Cir. 2004). The Court held that to do otherwise would frustrate the purposes of both §16(a) and § 16(b). *Id.* at 207. As the Court stated:

> However, Section 16 compels disclosure (through a Form 4) that is so clear that an insider's short-swing profits will be discovered without any investigation other than the putting together of two and two. The prophylaxis of Section 16 works by imposing an "absolute duty" of disclosure upon insiders, officers, and the other parties covered by its obligations, *Grossman* 72 F.Supp. at 378; that mechanism would be impaired if the tolling triggered by non-compliance was ended or defeated by mere inquiry notice, or by circumstances in which a person would or should have realized the non-compliance, or by the ability of a shareholder or company to piece together the substance of a Form 4 from disparate sources of information. We hold that the incentives of Section 16 are best served if tolling is triggered by noncompliance with the disclosure requirements of Section 16(a) through failure to file a Form 4.(footnote omitted) Such tolling should continue only until the claimant or (depending on the circumstances) the company gets actual notice that a person subject to Section 16(a) has realized specific short-swing profits that are worth pursuing.

Litzler v. CC Investments, L.D.C., 362 F.3d 203, 208 (2d Cir. 2004)

In accord, *Tristar Corp. v. Freitas*, 84 F. 3d 550 (2d Cir. 1996); *Rosen ex rel. Egghead.Com, Inc.* v. *Brookhaven*

Capital Management, Co. Ltd., 179 F.Supp.2d 330 (S.D.N.Y. 2002); *Morales v. Executive Telecard, Inc.*, 95 Civ. 10202, 1998 WL 314734 (S.D.N.Y. June 12, 1998); *Dreiling v. American Express Travel Related Services*, 351 F.Supp. 2d 1077, 1084-85 (W.D.WA. 2004), *aff'd* 458 F.3d 942 (9th Cir. 2006). As Judge Haight noted in *Brookhaven Capital*, supra, citing then District Judge Kaufman's opinion in *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957).

> If a defendant insider has failed to file §16(a) reports, a §16(b) plaintiff need do no more than prove that failure, which *ipso facto* establishes defendant's wrongful concealment preventing plaintiff's discovery of the claim, relieves the plaintiff of making a further showing of his own due diligence, and triggers equitable tolling. That is the conclusion Judge Kaufman reached in *Blau*, 157 F.Supp. at 819: "[T]he only fraud necessary to invoke the federal equitable doctrine is a violation of the statutory trading by insiders"; and concealment of that violation, "whether intentional or inadvertent, effectively prevents suit and demands the mitigating construction of the statute of limitations···" I agree with that conclusion, because it is the only way to implement effectively the public policy declared in § 16 of the Act.

Rosen ex rel. Egghead.Com, Inc. v. Brookhaven Capital Management, Co. Ltd., 179 F.Supp.2d 330, 338 (S.D.N.Y.2002)

Here, the complaint alleges that defendants reported in their Forms 4 and 5 that the option transactions were exempt from §16(b). Thus, the public was left with the incorrect impression that no §16(b) claims existed. Under

these circumstances, it is plain that the statute of limitations is tolled. The motion to dismiss on this basis should be denied.

POINT II

SEC RULE 16b-3(d) DOES NOT EXEMPT THESE BACKDATED OPTION GRANTS BECAUSE THEY WERE NOT LEGITIMATE TRANSACTIONS

Defendants also argue that their misconduct notwithstanding, they should have no liability because of the exemptive provisions of SEC Rule 16b-3. In essence, they claim that even if the options that they received were backdated and improperly issued, the exemption should still apply. Stated differently, defendants assert that the SEC in its rulemaking provides an exemption for options even if an insider fraudulently misrepresents the grant dates to obtain an "in the money" grant at the expense of public shareholders. We show below that defendants are plainly wrong. Defendants' construction of the Rule not only is at odds with the text of the Rule, it also completely ignores the SEC's purposes underlying the Rule and the statutory mandate of Section 16(b).

A. Rule 16b-3(d) Applies Only to Legitimate Transactions Made in the Ordinary Course of an Issuer's Business

Rule 16b-3(d) provides an exemption for certain transactions between an issuer and its officers and directors that meet certain objective "gate-keeping" criteria. SEC Rule 16b-3(d), in pertinent part, provides:

> *Acquisitions from the Issuer.* Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose, shall be exempt if:
>
> (1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;
>
> (2) The Transaction is approved or ratified, in compliance with section 14 of the Act, by … the holders of a majority of the securities of the issuer . . . ; or
>
> (3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercises or conversion) or its underlying equity security.

17 C.F.R. § 240.16b-3(d).

Defendants do not rely on the Rule's exemption for proper board approval contained in 16(b)-3(d)(1). Instead, they rely on subsection (d)(3) to provide an exemption,

alleging that they held the options for periods of six months following the dates of grant. But, in order for defendants' argument to succeed, this Court must find that the word "transaction" in the Rule applies to fraudulent or "illegitimate" transactions, without regard to the SEC's "gate keeping" criteria. This was not the intent of the SEC when it enacted the Rule or Congress when it enacted the statute.

In *Dreiling* v. *American Express Co.*, 458 F.3d 954 (9th Cir. 2006), the Ninth Circuit explored at some length the purpose and effect of the Rule. First, the Court analyzed the purpose of the statute.

> Congress enacted § 16(b) as part of the Securities Exchange Act of 1934 to prevent corporate insiders from exploiting their access to "information not generally available to others." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 592, 93 S.Ct. 1736, 36 L.Ed.2d 503 (1973). Section 16(b) reads in relevant part:
>
>> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale ... of any equity security of such issuer ... within any period of less than six months ... shall ... be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security.... *This subsection shall not be construed to cover ... any*

> *transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.*

15 U.S.C. § 78p(b) (emphasis added).

> In passing the statute, "Congress recognized that short-swing speculation by stockholders with advance, inside information would threaten the goal of the Securities Exchange Act to 'insure the maintenance of fair and honest markets.' " *Kern County,* 411 U.S. at 591, 93 S.Ct. 1736 (quoting 15 U.S.C. § 78b). Section 16(b) flatly prohibits a "class of transactions in which the possibility of abuse was believed to be intolerably great," *id.* at 592, 93 S.Ct. 1736, and does so by "impos[ing] a strict prophylactic rule with respect to insider, short-swing trading." *Foremost-McKesson, Inc. v. Provident Sec. Co.,* 423 U.S. 232, 251, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976). The statute identifies three classes of insiders--directors, officers and beneficial owners--and makes them liable, without fault or intended wrongdoing, for trading in their company's shares. 15 U.S.C. § 78p(b).

The Court went on to examine the purpose and effect of Rule 16b-3(d).

> The SEC adopted the 1996 version of Rule 16b-3(d) as part of a number of amendments to Rule 16b-3 to present a "simplified, flexible approach" to insider transactions. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 61 Fed.Reg. 30,376, 30,377 (June 14, 1996)[the "1996 Adopting Release"]. . . . The SEC . . . concluded that short-swing transactions between an insider and an issuer that *"satisfy ... objective gate-keeping conditions[ ] are not vehicles for the speculative abuse that section 16(b) was designed to prevent." Id.* Thus, the SEC enacted Rule 16b-3(d) because board or shareholder-approved insider-issuer transactions were "not contemplated within the purpose" of § 16(b).

458 F.3d 942 at 948 (*emphasis added*).

The Court noted also that the objective gate-keeping functions would serve as a curb on insider abuse:

> After notice and comment, the SEC determined that board-approved transactions between an issuer and an insider were unlikely to result in speculative abuse, and that the risk of such abuse was therefore tolerable. As amicus curiae, the SEC adds that in considering Rule 16b-3(d), it found that insider-issuer transactions did not pose an intolerably great risk of abuse because "*[b]oard or shareholder approval will remove the timing of the acquisition from the control of any one insider and also tend to assure that the acquisition is for a legitimate corporate purpose." See also Gryl v. Shire Pharm. Group PLC,* 298 F.3d 136, 145-46 (2d Cir.2002)(*emphasis added*).

Dreiling v. American Exp. Co., 458 F.3d 942, 950 (9th Cir. 2006).

1. The Regulatory History of Rule 16b-3(d) Demonstrates That It Was Concerned With Legitimate Issuer Transactions

The regulatory history of Rule 16b-3(d), as adopted in 1996, further supports the conclusion that it was concerned solely with issuer transactions with its corporate officers or directors which did not "present . . . opportunities for insider profit on the basis of non-public information" in furtherance of mandate of the statute. Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 61 Fed.Reg. 30,376, 30,377 (June 14, 1996).

The statutory policies of Section 16(b) are designed to prevent speculative abuse by statutory insiders which results in harm to the securities markets and the national economy. *See, e.g., Gollust v. Mendel,* 501 U.S.115,121 (1991) (quoting 15 U.S.C. §78b). Section 16(b) embodies Congress' judgment that certain types of insider trading are so fraught with the risk of speculative abuse that, like horizontal price fixing, they are subject to a *per se* rule, i.e., they should not be allowed under any circumstances. *See, e.g., Foremost-McKesson, Inc.,* 423 U.S. at 253 ("Congress thought that ***all*** short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs.") (*emphasis added*).

Rule 16b-3's extensive revision in 1991[2] included a rather complex and detailed set of rules governing the availability of the compensation-related exemption. Those revisions articulate quite clearly the problem that the rule was designed to address by stating that:

> Since many plans provide for grants or awards at least every 12 months, if there were no acquisition exemption, any sale of equity

[2] *Ownership Reports and Trading by Officers, Directors, and Principal Security Holders*, Release Nos. 34-28869; 35-25254; IC-17991, 56 FR 7242 (Feb. 21. 1991 (the "1991 Adopting Release")

> security by participating officers or directors would necessarily occur within six months before or after an acquisition, and therefore result in short-swing liability. ***Rule 16b-3 is intended to provide relief from this frustration of the legitimate use of employee benefit plans as a method of executive compensation, where the nature of the transaction and the safeguard imposed by the rule minimize the potential for abuse.***

1991 Adopting Release, 56 FR at 81,266.

Similarly, the SEC's 1995 Release[3] also explained that the purpose of the alternative proposal, later adopted as the Rule, was to facilitate ***legitimate transactions*** between an issuer and its officers and directors. Thus, the 1995 Release stated:

> ... the Commission has sought to craft a rule that, consistent with the statutory purpose of Section 16(b), erects meaningful safeguards against the abuse of inside information by officers and directors ***without impeding their participation in legitimate compensatory transactions*** that do not present the possibility of such abuse, and facilitates compliance.

1995 Release, 60 FR at 53833 (emphasis added).

Finally, in the 1996 release with respect to Rule 16b-3, confirms that the concept of ordinary course legitimate transactions lay at the core of the regulatory changes to Rule 16b-3(d). In connection with the decision to insert the words "other acquisitions" the Adopting Release states:

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[3] Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Release No. 34-36356, 60 Fed. Reg. 53832, 53834 (Oct. 17, 1995)(the "1995 Adopting Release").

> [The] [p]urpose is to exempt some participant directed transactions (such as deferral of bonuses into phantom stock and other deferred ***compensation programs)*** that are exempt under the current rule but would lack the exemption under the new rule....

1996 Adopting Release, 61 FR at 30380 (*emphasis added*).

The SEC releases contemporaneous with the adoption of Rule 16b-3(d) in 1996 never articulated an intention to provide a blanket exemption for all acquisitions of securities by a director from an issuer without regard to their legitimacy. Nor does any such statement appear in any of the SEC's releases discussing Rule 16b-3 dating back to the first time such a rule was adopted and continuing through 1991 when the previous form of the rule ultimately refined in the current rule 16b-3(d) was first proposed and then through its various incarnations in 1994, 1995 and 1996. To the contrary, the regulatory history is clear that the SEC's intention was to create an exemption for certain ordinary course transactions by issuer with its officers and directors.

Thus, it is quite clear that the SEC did not intend to exempt every issuer to insider transactions but only those transactions which were legitimate exercises of

corporate will.[4] Defendants are plainly not entitled to rely on an exemption under the facts alleged here.

POINT III

DEMAND SHOULD BE EXCUSED UNDER THE CIRCUMSTANCES PRESENTED HERE

Defendants also argue that the complaint should be dismissed because Strauss did not make a demand upon Affiliated to bring this suit. This argument too is without merit.

Section 16(b) confers standing on an "owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter . . . ." The court has the discretion to excuse demand on the issuer where demand would be futile or for other good reason, such

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[4] The SEC has not had occasion to publicly interpret this exemption in the context of the growing backdating of options scandal. However, if asked, it is unlikely that the SEC would sanction such conduct as a legitimate corporate transaction entitled to the exemption. But in the unlikely event that the SEC did read its regulations to permit an exemption for these backdated grants, this interpretation would not be entitled to deference because it flies in the face of the purpose of both §16(b)and its own regulations. *See, Director, Office of Workers Compensation v. Eastern Associated Coal*, 54 F.3d 141, 146 (3d Cir. 1995("We look to see whether the regulation harmonizes with the plain language of the statute, its origin and its purpose".).

as the expiration of the statute of limitations prior to the end of the sixty-day period. *See, e.g, Morales v. McIntyre Porcupine Mines, Ltd.*, U.S. Dist. LEXIS 11539 (S.D.N.Y. October 17, 1972); *Morales v. Mylan Laboratories, Inc.*, 443 F. Supp. 778 (W.D. PA 1978); *Grossman v. Young*, 72 F.Supp. 375, 380 (S.D.N.Y. 1947); *Benisch v. Cameron*, 81 F. Supp. 882, 885 (S.D.N.Y. 1948). *See also, DiLorenzo* v. *Edgar*, 2004 WL 609374 (D. Del. 2004) (cancellation of shares prior to expiration of sixty-day period sufficient to excuse demand).

It must be noted that the traditional concepts of demand required for derivative actions under Fed. R. Civ. P. 23.1 ("Rule 23.1") do not apply to §16(b). Unlike in traditional derivative cases, the issuer does not have the ability to dismiss cases under the business judgment rule. *Pellegrino v. Nesbit*, 203 F.2d 463 (9^{th} Cir. 1953); *DiLorenzo v. Edgar, supra,* citing *Cramer v. General Tel & Elec Corp.*, 582 F.2d 259, 276 (3d Cir. 1978). *In accord, Segen v. Comvest Venture Partners*, LP, 2005 WL 1320875 (D. Del. 2005). The purpose of demand in a §16(b) case is not to afford the issuer the opportunity to decide whether the litigation should go forward, but merely to allow the corporation to address the issue *before* allowing the shareholder to vindicate Congressional policy. *See, e.g,*

Colan v. Monumental Corp., 524 F.Supp. 1023, 1027 (N.D. Ill. 1981). It is simply a timing issue, allowing the company to pursue the claim in the first instance, if it intends to do so, but not foreclosing subsequent shareholder suit. *See*, *Pellegrino v. Nesbit*, 203 F.2d 463, 467 (9th Cir. 1953); *Levy ex rel. Mktg. Servs. Group, Inc. v. GE Capital Corp.*, 2001 U.S. Dist. LEXIS 13099 (S.D.N.Y. 2001), where the Court stated: "the congressional purpose [is] to cause disgorgement of short-swing profits by corporate insiders in favor of the corporation of which they are fiduciaries, even when the corporation is unwilling to prosecute such a suit and a derivative plaintiff brings suit instead". *Id.* at 19.

A. Demand Would Have Been Futile

There is no question that Affiliated would not have brought this lawsuit even had it received notice. The motion practice in this case makes that fact abundantly clear.[5]

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[5] The complaint makes the following allegations concerning demand:

> Plaintiff has not made demand on the Company to commence this action because such demand would be futile. Defendants control the Company and its Board of Directors, and it is believed that they will not take action against their own interests. Moreover, prompt action is required to avoid a

This case was filed on May 16, 2006. Obviously, had Affiliated wished to pursue these claims, it could have brought its own lawsuit at that time or moved to intervene as a plaintiff in this case. *Silverman v. Re*, 194 F. Supp. 540 (S.D.N.Y. 1961). Had Affiliated chosen either of these options, this Court could have allowed the issuer to pursue the claims and stayed Strauss' lawsuit. Instead, Affiliated elected to oppose the lawsuit and impede a recovery. The law is clear that where demand is futile, it will be excused. *Grossman v. Young*, 72 F.Supp. 375 (S.D.N.Y.1947); *Netter v. Ashland Paper Mills, Inc.*, 19 F.R.D. 529 (S.D.N.Y. 1956); *Weissman v. Spector*, 158 F. Supp. 789 (S.D.N.Y. 1958). The failure of Affiliated to bring this action or intervene as a plaintiff makes it obvious that demand would have been futile.[6] *See Grossman v. Young*, *supra*, finding futility where the shareholder-plaintiff sued before the sixty days had expired because, *inter alia*, issuer failed to appear in the action demonstrating its intent not to pursue the matter; *Berkwich* v.*Mencher*, 239 F.Supp. 792 (S.D.N.Y. 1965)(demand excused where corporation announced it would not bring suit and refused

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possible bar to the claims asserted herein under the governing two year statute of limitations. (¶ 17)

[6] Strauss wishes to advise the Court that he would welcome Affiliated's participation as a plaintiff in this lawsuit.

shareholder-plaintiff's offer to relinquish control of the lawsuit to the issuer).

It is obvious that dismissing this lawsuit for failure to make a demand will not vindicate the policy of the statute but only serve to undermine it.

B. Demand Is Excused Because of Potential Statute of Limitations Issues

The law is clear that the Court may exercise its discretion to excuse demand where the statute of limitations may bar the claims. *See*, e.g., *Morales* v. *Mylan Laboratories, Inc.*, 443 F. Supp. 778 (W.D. PA 1978); *Benisch v. Cameron*, 81 F. Supp. 882, 885 (S.D.N.Y. 1948). Although plaintiff believes that the tolling provisions of *Whittaker v. Whittaker, supra* and *Litzler, supra*, should be adopted by this Court, this Circuit has not definitively adopted the tolling provisions of those two cases. Because of this uncertainty, and because it was not plain from the defendants' SEC filings when the §16(b) claims accrued, plaintiff elected to file the complaint as soon as practicable to avoid a possible limitations defense as to either the claims pleaded or those that may be uncovered during discovery.

Plaintiff submits that the failure to make demand in this case is excused by the manifest disinterest of Affiliated in suing its insiders as well as the possible

effect on the limitations issues had he waited an additional sixty days to bring suit.

POINT VI

LEAVE TO REPLEAD SHOULD BE GRANTED

Defendants' Rule 12(b)(6) claim should be denied in its entirety. However, in the event that the Court finds that the claims have not been sufficiently pled, plaintiff requests leave to amend to correct the deficiencies pursuant to Fed. R. Civ. P. 15. *Justofin v. Metor Life Ins. Co.*, 372 F.3d 517, 525 (3rd Cir. 2004) (leave to amend pleading freely granted); *Shane v. Fauver*, 213 F. 3d 113, 115 (3rd Cir. 2000)(same).

Conclusion

The motions to dismiss should be denied.

Dated: Wilmington, Delaware
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CERTIFICATE OF SERVICE

I, Theodore J. Tacconelli, hereby certify that on September 25, 2006, a copy of the foregoing Memorandum of Law In Opposition to Motions To Dismiss was served electronically by CM/ECF and by hand delivery upon the following counsel of record:

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